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# 2020

# *Europe - U.S. Symposium on Building the Financial System of the 21st Century*

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# 2020 SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21st CENTURY: AN AGENDA FOR EUROPE AND THE UNITED STATES

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# Discussion Topic:

# The Role of the Government and Financial Sector in Supporting the Real Economy During the Crisis

# The pandemic and the real economy

- Historic declines in GDP, employment, trade
- Shape of recovery is highly uncertain
  - Some official forecasts of V-shaped recovery in US and Europe in second half of 2020 (not by Federal Reserve or IMF)
  - Are these realistic? Unless the pandemic is controlled, sustainable growth appears impossible
- Containing the pandemic
  - Failures of containment in US
  - Europe mostly more successful (except UK), but hot spots can reemerge
  - To fully restore economic growth, will need effective treatment, vaccine – how likely, and when?
- What will “recovery” look like?
  - Sectoral devastation in travel, hospitality, events
  - Widespread business failures likely, especially among SMEs
  - If many firms go out of business, where will employment gains come from?

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# Financial sector – performance so far

- Financial stability so far, despite unprecedented economic shock
  - Governments and central banks have been proactive
  - Post-crisis reforms have largely worked as intended
    - Bank capital and liquidity buffers have prevented failures so far
    - Clearing and exchanges functioning effectively
  - But some markets have required direct or regulatory interventions – CP, MMF, etc.
  - Most important: how long can financial stability hold if economic growth does not resume?

- How to ensure success of financial markets and regulation?
  - Key short-term indicators are credit provision, market liquidity
    - Banks have been central to success of policy support of SMEs
    - Financial markets have supported larger firms' liquidity and capital needs, facilitated government debt issuance, but only after central banks intervened to support market liquidity
  - Challenges remain
    - Short-term: disparities in uptake of credit based on ethnicity, sector, size of firm
    - What if we don't see V-shaped recoveries in US and Europe?
    - Long-term: debt build-up may be unsustainable for many firms, leading to future bankruptcies and/or zombie firms

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# Financial markets and credit to real economy

- Banks have helped to mitigate disaster so far, by providing needed credit
  - High levels of capitalization and liquidity put them in a position to continue lending
  - Only banks are in a position to act as credit pipelines to SMEs
    - But some concerns that banks' fears of NPLs, as well as CECL accounting for expected credit loss, may restrict new lending
  - Government action, including regulatory guidance and loan guarantees, have been essential to banks' lending and forbearance

- Financial markets
  - Much of non-bank sector has functioned as intended (albeit with government and central bank support)
    - Few liquidity-driven sell-offs - central clearing has prevented cascading defaults, equity and bond trading platforms have worked well
    - Massive issuance of government and corporate debt have been absorbed by investors
    - Long-term investors such as pensions, insurers, SWF have prevented asset fire-sales despite price volatility
    - However, asset prices have diverged from performance of real economy – will there be a reckoning?
  - Concerns expressed over CP, MMF
    - Significant outflows from institutional MMFs required asset sales and collateral calls, contributing to March/April liquidity freezes that only ended with Federal Reserve support
    - CP markets hit worst – liquidity only restored with support of liquidity injections and regulatory reassurance to banks

- Additional government intervention may be needed if/when debt sours

# Judging policy responses – short term

- Financial, fiscal and monetary policy have had positive effects in US and Europe
  - Lessons of global financial crisis being applied proactively – stimulus, liquidity
  - Contrast to considerable variability in public health responses
  - Long-term financial sustainability is a serious concern – will be determined by conditions in real economy, duration of pandemic
- Europe has been nimble and proactive, in contrast to 2008-10
  - ECB support has been large, swift, relatively flexible
  - Member-state fiscal actions
  - Joint EU bond issue (is this a “Hamilton moment”?)
  - Regulatory/supervisory focus primarily on banks
- US has also been effective and proactive
  - “Shock and awe” in monetary policy
  - Unprecedented fiscal effort, including PPP, extended unemployment, sectoral support
  - But Main Street Lending Program has been a failure – is there a role for Fed in supporting real economy? What kind of fiscal support is needed?
  - Cooperation across regulatory agencies to ensure comprehensive response (avoiding “regulatory whack-a-mole”)
  - Helped by existence of extensive crisis toolkit, bipartisan consensus for action

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# Cooperation within and across jurisdictions

- Among US public authorities
  - Fed and Treasury
    - Fiscal/monetary coordination
    - Fed has been subject to Treasury controls due to Dodd-Frank over lending to non-banks, both financial and non-financial (makes responsibility for terms of programs, as between the Treasury and Fed, unclear)
  - Cooperation across FDIC, Fed, OCC has made for consistent bank regulatory and supervisory response
- EU has also seen extensive coordination
  - Across regulatory and supervisory bodies, ECB, member governments
  - Joint bond issuance seen as historic
- High levels of technical cooperation across Atlantic, G7
  - Builds on trust and shared frameworks of action developed over many years
  - In contrast, low levels of cooperation among top political leaders
    - Political tensions have not interfered with technical cooperation
    - But will lack of political cooperation hamper crisis management and recovery down the road?

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# Banking sector – lessons learned

- Post-crisis reforms appear to have kept banks healthy in face of crisis
  - However, banks' unwillingness to dip into regulatory capital buffers may limit future lending
  - Strong averages conceal considerable variation in bank health, especially in Europe
    - Variation will likely increase depending on geographic and sectoral lending profiles
  - Long term health is more questionable
- Bank health has enabled governments' directed lending programs to work
  - True not only in Europe, where banks dominate credit provision, but also in US
  - Only banks have expertise and resources to quickly provide and service thousands of new SME loans
  - But what will be needed to significantly expand use of the Main Street Lending Program?
- Crisis tools require official backstopping and clear regulatory guidance
  - Banks do not want to get stuck with NPLs as result of lending into crisis
  - Most successful government lending programs are unconditional – 100% guarantee, clear criteria for eligible borrowers (contrast to Main Street)
  - Regulatory guidance gives important reassurance to banks
    - Removing risk-free assets from leverage ratio denominator
    - Clarifying accounting for pandemic-driven restructurings
    - But does regulatory forbearance raise the longer-term threat of NPLs and other credit events
- Stress testing and COVID sensitivity analyses have given supervisors essential visibility into macroprudential risks but unclear how this analysis should effect capital ratios and dividends and share buybacks

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# Future concerns – financial sector

- Likely rise in NPLs will challenge banks and regulators
  - Looming solvency crisis for non-investment-grade mid-sized and small firms?
  - How to understand balance between resilience, flexibility, and profitability?
- Disputes over regulation of non-banks
  - Some calls, especially in EU, for greater regulation of funds industry
  - Significant pushback against this point of view
    - CP market freeze largely due to non-participation by banks; US CP market comeback due to new guidance on risk weighting as well as Fed liquidity provision
    - Treasuries seized up, whereas derivatives did not – central clearing more important in crisis rather than types of investors
    - Macroprudential measures inspired by banking regulation would kill funds industry and exacerbate market liquidity issues
    - Inflexibility of US weekly liquidity minimum may contribute to illiquidity in time of crisis
- Financial infrastructures have worked as intended
  - CCPs, exchanges, trading platforms have avoided liquidity problems of uncleared OTC

# Future concerns – real economy & policy

- Pandemic and the real economy
  - No one knows how long it will last or how it will change long-term economic behavior
  - Are massive fiscal efforts in US and Europe economically and politically sustainable?
  - Potential for widespread business failures due to continued or renewed demand shock
  - Long-term effects of overleverage for those companies that survive will include slow growth, low interest rates

- Government intervention is pervasive – will this continue, and with what effects?
  - Are there contradictions between long-term policy goals and growth imperatives? (e.g., EU inclusion of ESG in financial regulation)
  - What will policy exit look like, and who will take responsibility for business failures as crisis credit provision is withdrawn?
  - EU & US have differing philosophical views on when govt should step in, role of market discipline, dangers of moral hazard
  - Inequality driven by pandemic and govt responses will raise social tensions and economic nationalism – how can this be managed?

# UPCOMING EVENTS

**The Rise of Private Equity: Implications for Public Markets and Investor Access**
**Virtual Roundtable, August 20, 2020**

**China – US 2020**
**Virtual Symposia, September 10-11, 2020**

**The Role of Asset Management in ESG Investing**
**Virtual Roundtable, September 17, 2020**

**Japan – US 2020**
**Virtual Symposia, November 5-7, 2020**

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